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# FARM CORPORATIONS

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In Ontario approximately 12% of farm businesses are incorporated. This number has been growing steadily as farm businesses become larger and the corporate tax rate for small businesses continues to fall. This Factsheet will help farm business owners to understand the corporate structure and to decide if incorporation makes sense for their farm business. This Factsheet is one in a series covering business structures.

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## SECTION 1 — THE BASICS OF INCORPORATION

### WHAT IS A CORPORATION?

A corporation is a "separate legal entity," which means it can do anything a person can. It can:

- carry on business
- buy, own and sell assets
- hold mortgages and have debt
- file income tax returns.
- rent land or other assets **from** you
- rent assets **to** you
- enter into contracts

Most small businesses are incorporated under the *Business Corporations Act of Ontario*. The incorporating parties must present articles of incorporation to the Ministry of Consumer and Business Services.

### WHY INCORPORATE?

There are both advantages and disadvantages to the corporate business structure. While farm businesses should consider all the factors, the tax advantages are often the main reason for considering incorporation. An important point to remember is that much of the tax advantage comes from **deferring** tax. This means that at some point in the future the tax will have to be paid. The longer the deferral the greater the advantage. If the business is not expected to continue beyond a 5–year time horizon then the cost of incorporating may not make sense. Other farm businesses may decide not to incorporate because of personal preferences or because of other disadvantages outlined in *Table 1*.

### HOW IS MONEY SAVED OR TAX DEFERRED?

As stated earlier a corporation allows for the deferral of tax. This deferred tax can then be used to finance the ongoing operations of the business. Deferring tax is possible because of the low tax rate on the first $200,000 of active business income of the corporation. The current rate is 19.62% on the first $200,000 and 42.12% on income beyond that level. With scheduled decreases at both the federal and provincial level, these rates are trending downward. The lower rate is of no advantage however if the shareholder(s) must remove all of the profits from the company for living expenses. *Table 2* demonstrates how a tax deferral might be achieved in a company with 3 shareholders and a net income of $150,000. In the example there is approximately a $10,000 advantage by taking minimal salary and retaining profits in the corporation.

For income over $200,000 the traditional approach has been to "bonus down", that is to pay shareholders a bonus payment, down to the $200,000 level so as to not be taxed at the higher level. This is done because the total tax paid by the corporation at the higher rate plus the tax paid on the dividend by the shareholder is higher than if the shareholder paid personal rates on money paid out as a salary from the corporation.

With the decreasing rates however the bonus down strategy may not be so clear. In some cases if the business can earn a significant return on income left in the corporation it may make sense to pay the higher corporate rate and leave the profit in the company. Shareholders should consult their accountant for the best approach.

A second advantage of the corporate structure is the savings on interest paid on debt held by the corporation. This is possible because the corporation pays off debt using dollars that have been taxed at the lower corporate rate. This is why it is desirable to have the corporation hold as much of the debt as is practical.

A third advantage is the use of the corporate structure to maximize personal tax credits for shareholders. This is especially advantageous where shareholders have young children. Salary paid to the parents can be kept at a level that maximizes the child tax benefit and other credits.

**TABLE 1. Advantages and Disadvantages to Incorporating a Farm Business**

| Advantages | Disadvantages |
|---|---|
| **Tax advantage** — the corporate tax rate is lower than the highest personal rates so there is a tax deferral on money that is left inside the corporation. The longer you defer the payment of taxes the greater the advantage. There is also the opportunity to maximize shareholders personal credits. | **Complexity** — the structure is more complex and requires more professional advice. |
| **Faster Repayment of Debt** — because the corporation is taxed at a lower rate it can pay off the debt faster than the individual who is making the payments with after tax dollars paid at a higher personal rate. | **Loss of Capital Gain Exemption** — a corporation does not have any capital gains exemption. |
| **Liability** — there are some advantages to be gained from the limited liability however most lenders require personal guarantees so the individual remains liable for the corporate debts. | **Initial and Ongoing Costs** — since the corporation must also file tax statements in addition to the shareholder the ongoing costs are usually higher. |
| **Perpetual Succession** — a corporation has perpetual existence that can allow for a smooth transfer between generations over a period of time. | **Loss of Personal Tax Benefits** — if land is placed inside the corporation there is a potential loss of the capital gains exemption on the principle residence. |
| **Flexibility** — the structure is highly flexible in terms of assets owned and payment of shareholders. | |
| **Capital Gains Exemption Utilization** — the personal capital gains exemption can be utilized on transferring assets into the corporation and is available on the sale of the shares of the corporation. | |

**TABLE 2. Tax deferral example**

| | All corporate income paid out as salary | Minimal salary with the remainder held in corporation |
|---|---|---|
| Personal Income | 50,000 each = $150,000 | $30,000 each = 90,000 |
| Income Tax – personal | ~ $ 42,840 | ~ $ 20,700 |
| Profit left in company | | $ 60,000 |
| Corporate tax (60,000 x 19.62%) | | ~ $ 11,772 |
| Net amount remaining in corporation ( 60,000 - 11,772) | | $ 48,228 |
| Total Tax paid | ~ $ 42,840 | ~ $ 32,472 |
| Tax Deferral | | $ 10,368 |

## OTHER FACTORS TO CONSIDER BEFORE INCORPORATING

### Family Goals and Comfort Level

A corporate structure may satisfy many of the criteria that the business has set, yet fail to match the family's goals and comfort level. Even if it is likely to help them reach their goals, the formality and complexity may be more than the family wants to accept. The business owners will want to ask themselves if they are comfortable with:

- learning new terminology such as shareholder loans, dividends, common and preferred shares.
- no longer directly owning all the assets of the business.
- keeping personal financial affairs separate from the corporation.
- depending more on advisors for dealing with the tax and technical issues of the business.

### Limited Liability

A corporation provides some limit to liability. If the corporation fails to pay its debts, the corporation's assets offered as security will be pursued. Lenders often require shareholders to personally guarantee corporate loans which means that the lender can pursue the guarantor and their personal assets. If no guarantee is in place then personal assets are protected.

In the case of a lawsuit for damages the corporation is sued and not the shareholders. Liability insurance should be used to protect against such a claim. In recent years the corporate structure in some cases has not protected the shareholder executives from personal liability.

### Utilization of Capital Gains

The capital gains exemption is often used as a justification for incorporating the farm business. While this

is an important tax advantage it should not be the only reason to incorporate. The recent reduction in the capital gains inclusion rate to 50% means that one half of a capital gain is included in income and subject to regular income tax. The other half may be subject to the alternative minimum tax. The capital gains exemption is available for qualified farm properties that includes:

- farm land and buildings
- shares in a family farm corporation
- an interest in a family farm partnership
- quota (*referred to as eligible capital property*)

The exemption is also available for partners in a partnership, since taxes are paid at the individual level. Corporations, however, do not have any exemption available to them.

**What does "triggering the capital gain" or "crystallizing it" mean?**

It means that you are purposely creating a capital gain then using your exemption to offset the gain. Transferring an asset to a corporation could allow you to trigger a capital gain and utilize the capital gain exemption.

The corporation itself has no capital gain exemption, but the shares of the corporation are eligible. Selling shares to an arm's length party however can be difficult since a stranger would usually prefer to purchase the assets. A method to overcome this reluctance is to reduce the price of the shares, which acknowledges the tax liability that the new owner would be taking on. In this way the seller would receive a higher price than would have been the case in a company wind up, and the buyer gets the assets at a lower price than what they would have been worth outside the company. In addition the purchaser can in some cases increase the cost base of the land in the corporation by winding up the existing corporation into a new company.

For more detail on the above tax issues refer to the OMAFRA Factsheet *Taxation on the Sale of Farm Business Assets*, Order No. 00-089.

**WHEN SHOULD YOU INCORPORATE?**

There are various guidelines but often the deciding factor is how profitable the business is. If the business is generating significant profits then there is the opportunity to leave part of those profits in the company to be taxed at the lower rate. If all the profits must be removed for family living expenses then this advantage is lost. The total family income should be considered. For example a farm with net income of $50,000 a year might be a good candidate if a spouse is earning $45,000 of off-farm income that can be used for family living. As a rule of thumb, when family income reaches $70,000 the tax advantages may merit a look at incorporation.

**WHAT DOES IT COST TO SET UP A CORPORATION?**

While it will vary according to the complexity of the business you can expect to pay between $3000 to $5000 to set up a corporation and about $500 to $1000 more than for annual accounting fees than you are currently paying

Incorporation costs will include provincial fees and professional fees for legal and tax advice. The annual accounting cost is usually higher because of full financial statements and corporate tax returns. However, if the farm already has full financial statements, the added annual cost may not be significant.

The provincial fee for establishing a corporation is $360. This does not include a name search that must be done through a private name search company. The Companies Branch of the Ministry of Consumer and Business Services can advise you of the names of search companies. Once a name search is completed, articles of incorporation are filed with the province. Because of the time required for a name search, many people form a so-called numbered company. For more details on the steps to incorporating see *Appendix 1*.

## SECTION 2 — FORMING A NEW CORPORATION

Forming a corporation involves three areas that require thoughtful discussion with your advisors. These areas are:

- Share Structure
- Shareholder Agreement
- Personal or Corporate Ownership of Assets

**SHARE STRUCTURE**

Share structure is important because it defines the ownership of the assets of the corporation, the control of the business and how dividends are distributed. In corporations with only one shareholder this can be quite simple. As the number of shareholders, and in particular when a second or third generation is involved, it becomes more important to have a share structure that is fair to everyone and defines the ownership and control of the farm corporation.

If the corporation has more than one class of shares then the rights and privileges of each class must be determined. The right to vote and receive the remaining property must be attached to at least one class of shares although both do not need to be attached to the same class. Usually the common shares have voting rights although in some cases parents may hold special shares that do not grow in value but have voting rights attached. This allows them to maintain control of the business and at the same time enable the children to participate in the growth of the business.

## COMMON OR GROWTH SHARES

Common or growth shares represent the net value of the assets after the corporate debts and value of special shares are deducted. Common shares have to be issued for some consideration i.e. purchased, but this is usually for a very low amount such as one dollar per share. Any future growth or decrease in value affects the value of the growth shares.

## SPECIAL SHARES

Special shares, which are often referred to as preferred shares, have a fixed value and may bear dividends. A dividend is a pay out on a per share basis to the shareholder. Special shares get a fixed value when they are set up. Often an arbitrary round number like $100 is used for convenience. One advantage to using special shares in a corporation is that they are easier to retract or issue if Canada Customs and Revenue Agency (CCRA) should question the value used for asset being rolled into the corporation. If for example, CCRA reassessed an asset at $50,000 more than the price it was transferred at, then a price adjustment clause in the purchase and sale agreement could allow an additional number of special shares to be issued to the shareholder and the tax deferred rollover would be preserved. If only common shares had been used the company would have to be re-valued before you could determine how many more common shares had to be issued.

## SHARE RIGHTS

Any share can have rights assigned or attached to it. These rights should be listed in the Articles of Incorporation or Corporation Bylaws. Some of the more common rights that can be attached to shares include:

**Redeemable Shares:**

This gives the shareholder a right to redeem or sell back to the corporation their redeemable shares. Other conditions, such as the number of shares that can be redeemed in one year, notice period prior to redemption, etc. may also be stipulated.

**Retractable Shares:**

A retractable share gives the corporation the right to buy back shares. Special or preferred shares would typically be "retracted" at the par or cumulative value. A predetermined price or predetermined method of calculating a value would be used to value the common shares.

**Cumulative Shares:**

Some shares are entitled to a dividend payment each year. However, there may be years where the corporation does not pay dividends. If the shares are cumulative the dividend not paid will still by owed to the shareholder. In other words, the corporation is obligated to pay the dividend in the next or future years. The dividends not paid would accumulate until they are paid.

**Non-Cumulative Shares:**

For a non-cumulative share, the corporation is not obligated to pay "missed" dividends in future years. In other words, unpaid dividends do not accumulate.

## SHAREHOLDER AGREEMENT

The shareholder agreement outlines how the corporation will operate. It usually covers the establishment, operation and termination of the corporation. The shareholder agreement is most common in companies with multiple shareholders. This is because it is used to cover areas of potential conflict and protect minority shareholders in areas not covered in the Articles of Incorporation or in the by-laws. For example in a company with 3 shareholders it would be possible for 2 of the shareholders to issue new shares to themselves and exclude the third shareholder, if the by-laws indicated that a simple 2/3$^{rds}$ majority was all that was required to do so. A shareholder agreement would address this issue.

Issues that are frequently addressed are:

- rights of a shareholder to nominate directors or appoint officers
- management issues such as day to day management, banking, and responsibilities
- conduct of a shareholder with respect to other business involvement
- the right to participate in future share offerings, and anti dilution provisions
- the transfer of shares either to individuals or to holding companies
- rights of first refusal and buy-sell arrangements
- valuation of shares, how this will be done
- death or disability of a shareholder, including clauses about life and disability insurance
- retirement timeframe for shareholders
- dispute resolution, what mechanism will be used and the consequences

## PERSONAL OR CORPORATE OWNERSHIP OF ASSETS

The choice between personal or corporate ownership of assets should be considered in light of the tax advantages, personal preferences and the degree of desired flexibility in the future. Assets can be owned personally and leased to the corporation or the corporation can purchase and own them. This can be done in any combination that the shareholders wish. For an explanation of the tax issues and terminology refer to the OMAFRA Factsheets *Taxation on the Sale of Farm Business Assets,* Order No. 00-089 and *Taxation on the Transfer of Farm Business Assets to Family Members*, Order. No. 01-055.

Generally assets such as inventory and equipment are placed inside the corporation. Other assets such as quota and land are sometimes held outside the corporation for reasons explained in the next section. The *Income Tax Act*

allows farming assets to be sold to the corporation on a tax deferred basis as long as the appropriate elections and forms are filed with CCRA. This is called a "rollover" in tax terminology. To accomplish this the owner would transfer the asset to the corporation at it's tax cost otherwise known as the "adjusted cost base" (ACB). This would not trigger any capital gains or other tax cost. The corporation however is required to give the shareholder consideration equal to Fair Market Value (FMV) of the asset. The corporation does this through either shareholder loans or shares. The shareholder loan represents the tax cost of the asset. The payment of the shareholder loan by the corporation therefore is tax free to the shareholder. If a shareholder transfers an asset at higher than its ACB they would incur a capital gain and if the capital gain exemption available to them they could use it. The shareholder loan would then reflect the new ACB or tax value of the asset (see case 2 below). Shares are taken by the shareholder for any value between the ACB and the FMV. *Table 3* below shows some examples. The payments the corporation makes to the shareholder on the shareholder loan are tax free to the shareholder. These payments are made from the corporate earnings that have been taxed at 19.62 % and are not a tax deduction for the corporation. *Table 4* outlines the results of transfer values process.

## INCORPORATING A PARTNERSHIP

There are two methods that can be used to incorporate a partnership:

- incorporation of the assets of the partnership, followed by a wind-up of the partnership; and
- incorporation of the interests in the partnership followed by a wind-up of the partnership into the company.

In either case there are specific rules that need to be followed. It is important to seek tax advice on your specific situation.

## TRANSFERRING ASSETS

### Land

The decision between maintaining personal ownership of land or transferring it into the corporation is often difficult to make. Every situation is different. There are both advantages and disadvantages to transferring land into the corporation. *Table 5* lists some of these.

**TABLE 3. Transferring Assets Into a Corporation**

| Transfer Values | Result |
|---|---|
| **Case 1**<br>Transferred at the adjusted cost base (ACB) | • No capital gains triggered<br>• Shareholder loan owed to shareholder for the amount of ACB<br>• Special shares taken by shareholder for the amount between the ACB and FMV<br>• If the asset is sold in the future the capital gain is calculated from the ACB. |
| **Case 2**<br>Transferred between ACB and FMV | • Some capital gain triggered and capital gains exemption used.<br>• Shareholder loan to shareholder for the amount of new ACB<br>• Special shares taken by shareholder for the amount between the new ACB and FMV |
| **Case 3**<br>Transferred at FMV | • All the capital gain triggered and capital gains exemption used.<br>• Shareholder loan to shareholder taken for the full amount of FMV |

**TABLE 4. Results of Transfer Values**

| | Case 1 | Case 2 | Case 3 |
|---|---|---|---|
| ACB of Asset | $ 200,000 | $ 200,000 | $ 200,000 |
| FMV of Asset | $ 600,000 | $ 600,000 | $ 600,000 |
| Transfer to Corporation | $ 200,000 | $ 300,000 | $ 600,000 |
| **Results** | | | |
| Shareholder Loan | $ 200,000 | $ 300,000 | $ 600,000 |
| Preferred Shares | $ 400,000 | $ 300,000 | $ — |

**TABLE 5. Advantages and Disadvantages to Transferring Land to a Corporation**

| Advantages | Disadvantages |
|---|---|
| **Utilize the capital gain** — transferring the land allows the use of the capital gains exemption. | **Loss of Capital Gain Exemption** — a corporation does not have a capital gains exemption. If the land does not have large capital gains but you expect higher gains in the future, you may want to keep land out to use the capital gain exemption in the future. |
| **Pay Off Debt Faster** — if the land has a large mortgage, the corporation can pay the debt off faster because of its lower tax rate. | **Loss of Flexibility in Future Transfers** — if there are two or more children involved in the business keeping the land out provides flexibility if they decide to farm separately at a later date. |
| **Create Shareholder Loans** — placing land inside the corporation allows you to create shareholder loans. These are paid back to the shareholder tax-free. | **Taxable benefits** — if a personal residence is transferred into the corporation with the land, the shareholder can incur taxable benefits since they have the use of the house the corporation owns. |
| **Business Organization** — having all the assets inside the corporation may be appealing to those who want the business structure to be as straight forward as possible from a tax and legal standpoint | **Loss of Capital Gains Exemption on Personal Residence** — capital gains on a personal residence is exempt from tax. However if the corporation owns the house there is no exemption. |

**TABLE 6. Land Transfer**

| | Deferral with no Capital Gain Exemption Used | Capital Gain Exemption Used |
|---|---|---|
| ACB of Land | $100,000 | $100,000 |
| FMV of Land | $400,000 | $400,000 |
| **Sale to Corporation** | **$100,000** (1) | **$400,000** (2) |
| Capital Gain | 0 | $300,000 |
| Taxable Gain (50% of Gain) | | $150,000 |
| Taxable Gain Exemption | | ($150,000) |
| **Results** | | |
| Shareholder Loan | $100,000 | $400,000 |
| Preferred Shares | $300,000 | $0 |

1. The parent might hold a mortgage for $100,000.
2. Holding a mortgage for a significant portion of $300,000 should minimize problems with minimum alternative tax as long as it qualifies as a reserve.

In many cases land is transferred into the corporation because of the desire to trigger a capital gain and use the capital gains exemption or because a significant portion of the debt is attached to the land.

When land is transferred the parents usually trigger any gains and take back a shareholder loan up to the tax value. Payments on the loan come out of the corporation tax-free to the shareholder and so this loan is sometimes used in estate planning to deal with non farming kids or for the retirement needs of the parents.

There are situations where it may be advisable to leave land outside the corporation. Where there is more than one parcel of land the family may desire flexibility for estate planning reasons. Or a farm property may be in an area that is close to an urban area and the land values are expected to increase in excess of parents' $500,000 exemption. In that case the land might be left out on the chance that the children's $500,000 exemption might be used in the future.

In the example in *Table 6* the land could be transferred at the adjusted cost base or at the FMV and the capital gains exemption used. If the exemption was not available, a capital gain reserve could be used to that would spread out the gain over a number of years if the parent held a mortgage.

**Example from Table 6** — A piece of land worth $400,000 transfers into a corporation. The adjusted cost base (ACB) is $100,000. The capital gain on the land is $300,000. Instead of taking a shareholder loan for just $100,000 and preferred shares on the rest the owner could take a shareholder loan for the full $400,000. This would

trigger a capital gain that the owner could then apply his capital gain exemption against.

**Results** — The corporation gets the land at a higher ACB, which means that if the land is sold sometime in the future, the capital gain will be calculated from the $400,000. The shareholder can receive tax-free payments from the corporation on their shareholder loan.

**Farm House**

If land and the principle residence are transferred to the corporation a loss of the principal residence exemption for capital gains may result. As well, the corporate–owned house could result in a taxable benefit to the shareholder living in the house. Some advisors specifically exclude the house in the land transfer and then charge the shareholders rent for the land that the house sits on. In this way the principal residence exemption is preserved. On farm properties with 2 houses only one can be claimed as the principal residence.

**Quota**

A farmer can transfer quota into a corporation and claim the capital gains exemption on the increase in value. However, the increase in value of the quota cannot be added to the cumulative eligible capital account pool (which is similar to CCA classes) and depreciated. This higher value will reduce any gain on a future sale by the company. Like other assets the shareholder can hold a shareholder loan allowing tax-free payments to the shareholder.

Similar to land, if the shareholder anticipates the quota will increase in value it would be beneficial to hold the quota personally, rather than in a corporation — and be able to use the capital gains exemption on a future sale or transfer. When the corporation sells the quota the proceeds will qualify for the small business tax rate of 19.62%, as long as the quota was used in the active business.

**Inventory**

Crop and livestock inventory can transfer tax deferred into the corporation. But remember — sooner or later the tax has to be paid. Some advisors suggest taking preferred shares for the value of the inventory. This means that the shareholder receives the full value of the inventory and the company pays the tax when it sells the inventory. This approach would be a disadvantage to other shareholders, since the company now holds the tax liability. If the other shareholders are children they may happily accept this liability because they obtained shares by way of gift or at a reduced rate.

Where other shareholders are involved a better approach would be to sell the inventory to the corporation for full value and the shareholder take a demand note from the company. This would be advantageous for 4 reasons, as long as both the shareholder and corporation file income tax on a cash basis:

- The company receives a deduction when it makes payments on the note.
- The shareholder could spread the income out over any time period chosen.
- This is fair to other shareholders because the company is not paying taxes on the inventory sale by the corporation.
- The payments on the note from the corporation are business income the shareholder must pay CPP on but are considered eligible income for calculating RRSP contributions.

**Capital Gains and Inventory**

If someone rolls part of the business assets — such as inventory, quota and depreciable property into a corporation just before selling the shares in order to convert income items to a capital gain — the anti-avoidance rules can be used by tax authorities to disallow the capital gains exemption. However, if all of the assets are rolled into a corporation and the shares are sold, the anti-avoidance rules should not apply. Because family members normally acquire shares, the exemption can be used to provide the parent with higher proceeds and the child with a higher ACB

**Corporation Rollover Example**

*Table 7* and *Table 8* outline an example of farm incorporation. The tax calculations are estimations only. This example shows the scenario of a farming child who has built up some ownership in assets. The assumptions are that all of the assets are part XI assets, which means they have been purchased after 1971.

The results of this transfer would be as follows:

**Father**

- He would continue to hold 50% of the land personally. The corporation could rent this from him.
- He would have utilized his capital gains exemption on the quota. An estimated calculation would have resulted in $187,500 of income that would be eligible for the capital gain (assumes $40,000 depreciation and a $0 1971 value). This means he would still have exemption remaining.
- He would hold a shareholder loan for $575,000, which is the fair market value of the quota.

He would hold a note on the $90,000 of inventory. The corporation could pay him back over time in order to spread out the income. *See explanation on inventory transfer in Section 2.*

**TABLE 7. Transfer Examples**

| Assets | ACB (UCC or CEC)[1] | FMV | Capital Gain or Recapture | Percentage Ownership | | |
|---|---|---|---|---|---|---|
| | | | | Father | Mother | Child |
| Land | 125,000 | 600,000 | 475,000 | 50% | 50% | 0% |
| Quota [2] | 100,000 | 575,000 | 475,000[2] | 100% | | |
| Buildings | 60,000 | 200,000 | 140,000 | 50% | 50% | |
| Machinery | 50,000 | 90,000 | 40,000 | 80% | | 20% |
| Inventory | | 120,000 | 120,000 | 75% | | 25% |
| **Total** | **$ 335,000** | **$ 1,585,000** | **$ 1,250,000** | **$ 1,037,000** | **$ 300,000** | **$ 48,000** |

1. UCC is the undepreciated capital cost and CEC is the cumulative eligible capital
2. The calculation for the deemed taxable capital gain on quota is more complex than just taking 50% of the capital gain as is the case with an asset such as land. See Factsheet *Taxation on the sale of Farm Assets,* Order No. 00-089

**TABLE 8. Transfer Results**

| Assets | Transferred to Corporation | Value Transferred at: | Capital Gain, Recapture or Income Triggered | | | |
|---|---|---|---|---|---|---|
| | | | Total | Father | Mother | Child |
| Land | No | | — | — | — | — |
| Quota | Yes | 575,000 | 475,000 | 475,000 | — | — |
| Buildings | No | | — | — | — | — |
| Machinery | Yes | 50,000 | — | — | — | — |
| Inventory | Yes | 120,000 | 120,000 | 90,000 | — | 30,000 |
| **Total** | | **$ 745,000** | **$ 595,000** | **$ 565,000** | **0** | **$ 30,000** |

**Mother**

- Continue to hold her 50% of the land personally. The corporation could rent this from her. She could utilize the capital gains exemption at a later date.

**Child**

- Would hold a $30,000 note from corporation for inventory.

The common shares would be distributed in a manner that met the shareholders desire to maintain control and participate in the growth. An example might be Father 30%, Mother 30% and Child 40%. This would still give the parents voting control. If the parents wanted to give children a greater share of the growth yet still maintain control they might consider attaching voting control to the special shares.

**Net Income Stabilization Account (NISA)**

Personal NISA accounts can be rolled into a corporation. The best strategy should be discussed with your accountant. There are 3 options:

- Close your personal account and get paid out, then open a new corporate account. Consider the timing of your personal account closure. It may be advantageous to maintain the account and utilize any remaining contribution room available.
- Roll your personal account into the corporation
- Continue to maintain both the personal NISA account and corporate NISA shareholder account.

If a farmer wishes to leave a personal account in place they can roll it to the company before withdrawal to avoid the high rate personal tax.

## SECTION 3 — OPERATING THE CORPORATION

The day to day operation of the farm business is not affected by incorporation. What does change is the relationship of the owner to the business. This is especially true when it comes to how shareholders are paid by the corporation. A corporation gives the shareholder increased options and flexibility regarding remuneration.

### TAKING MONEY OUT OF THE CORPORATION

There are 4 ways that the shareholder can receive money from the corporation:

- Salary
- Dividends
- Repayment of Shareholder loans
- Rental payments for the use of personal assets

Each of these has advantages and disadvantages as outlined in *Table 9.*

**TABLE 9. Payments to Shareholders**

| Method of Payment | Advantages | Disadvantages |
|---|---|---|
| Salary | • Can take out just enough to use up the lower tax bracket<br>• Can use to contribute to an RRSP<br>• Can use to contribute to CPP if desired<br>• Salary payment is a deduction for the corporation | • Must make CPP contributions on salary.<br>• If the salary is significant then higher personal tax rates will apply. |
| Dividends | • Taxed at a lower tax rate than salary | • CPP does not need to be paid<br>• Dividends are not a deduction for the corporation |
| Repayment of a shareholder loan | • The repayment of a shareholder loan represents principal payments on an asset that the shareholder has sold to the company. As such it is tax free | • Must have transferred assets to the corporation or paid corporate expenses personally in order to create the loan.<br>• Shareholder loan payments are not a deduction for the company |
| Rental payments for use of personal assets | • Rental payments can be used to make RRSP contributions, but CPP is not required to be paid on them<br>• Rental payments are a deduction for the corporation | • Rental rate must be reasonable<br>• Shareholder must continue to hold personal assets |

**Dividends Verses Salary**

Dividends and salary are the 2 most common methods of paying shareholders. If the corporation pays a shareholder salary the corporation is able to claim an expense and reduce the income that it pays tax on. The salary is then taxed in the hands of the shareholder. Salaries do not have to be paid according to percentage of share ownership. So if a shareholder only owned 20% of the shares they could still receive a larger percentage of the money paid out in salaries. They do not have to be paid in the same ratio but can be paid a salary for the work they do. In this way a parent can still pay a minority shareholder child a fair wage for their contribution to the business.

A dividend is a payment to the shareholder usually based on the number of shares that the shareholder has. The corporation pays the shareholder with money it has already paid tax on and cannot claim the dividend payment as an expense. The shareholder is able to use a dividend tax credit to offset the tax they will have to pay on dividends, since the company has already paid some tax on the amount distributed to the shareholder.

There are some important differences to consider with regards to salary or dividends. Canada Pension Plan (CPP) contributions must be paid on salary. This can be significant since levels for CPP contributions are increasing. For the self-employed person it means paying double what an employee would have to pay. CPP contributions are not required on dividends. The downside of dividends is that you do not have any earned income to use in making a contribution to an RRSP.

If the corporation is renting any assets from you, these payments can be used in calculating RRSP contributions.

**What Is The Best Method?**

There is no one best method. Each shareholder should discuss their situation with their accountant at the end of the year to decide what combination would be most advantageous. For instance, if you had a large shareholder loan you might take only $7412 in salary in order to use up your tax-free personal deduction and take whatever else you needed to live on in shareholder loan. This would provide you with tax free income and at the same time maximize your tax credits. Or you might want to increase your child tax benefits. In that case enough salary would be taken to maximize the working income supplement. You would decide with your accountant what was the best way for you to pay yourself and the other shareholders.

**Financial Statements**

Filing a complete set of financial statements is required of farm corporations. This may help large complex businesses to keep their affairs in order. The corporation must file an Income Statement, Balance Sheet and Statement of Change in Financial Position.

## SOURCES OF CAPITAL AND REPAYMENT OF CREDIT

Theoretically, investor capital, in addition to borrowing, is possible for a corporation to acquire. However, this is rare. Normal financing, with some added security arrangements, is most common. For the profitable farm which also has sizeable borrowings, the after tax dollars available to make principal payments are greater than with a personal operation.

## SECTION 4—LEGAL ISSUES

This section covers some of the legal issues business owners should consider. However it is not a comprehensive discussion. As always, sound legal counsel is advised.

### MINORITY SHAREHOLDER ISSUES

Minority shareholders are sometimes concerned about how their concerns will be addressed in the corporate structure. The majority shareholders have a legitimate right to maintain control in running the business. However the minority shareholder can negotiate so that on certain issues unanimous consent would be required. The entry of other shareholders into the business might be one of those issues.

Other issues that a minority shareholder might want to be included in the shareholder agreement are:

- **Pay Increases** — Inserting appropriate management provisions that outlined what their pay would be and how increases would be determined.
- **Change of Control** — Provisions for a "stepped" acquisition of shares is a method for handling the change of control at a later date.
- **Leaving the Company** — It is important to include certain "buy/sell" provisions in the shareholder agreement. These would dictate the manner and at what price a shareholder could sell their shares to the existing shareholders.

#### Business Corporations Act (BCA)

The *Business Corporations Act* (BCA) provides several safeguards for the minority shareholders interests. Minority shareholders can "dissent"; that is, vote against a number of particular actions proposed for the corporation. The result of a dissenting vote can lead to the mandatory purchase of those shares at a fair market value. The *Act* also protects an officer, director, shareholder or former shareholder who has been unfairly dealt with by the other shareholders by the use what is known as the oppression remedy. This provides significant remedies for a minority shareholder that feels their interests have been abused.

### FAMILY LAW AND THE FARM CORPORATION

The *Family Law Act* (FLA) is principally designed to deal with marriage breakdown. The FLA addresses 2 separate issues: the division of property and a spouse's entitlement. The entitlement could take the form of a continuing periodic payment to a dependency or a lump sum payment. The FLA does not provide for the actual physical division of the property but rather divides the "value" of the properties. This means that after the calculation is made, if one spouse has assets of greater value than the other does, an equalization payment from the spouse with greater assets would be made so that each spouse's asset value was equal. Shares in a corporation would be included in this calculation. In this sense the corporate structure does not provide any greater stability in the event of a marriage breakdown than any other structure.

#### Marriage Contracts

Marriage contracts are used to try to minimize the affect of a marriage breakdown on a business. An appropriate time to consider such a contract might be when a new farm business structure is being put in place. For instance if new agreements are being drawn up then all the partners or shareholders could consider requiring each shareholder to have a marriage contract.

For example if one of the spouses is a partner in a farm business that has grown in value during the time they were married, that increase is included in the equalization of assets. A domestic contract attempts to exempt those farming assets from the calculation of net family property (which is what gets divided).

This will likely satisfy the partners, but probably not the spouses. The non-farming spouse will likely want some "compensating" provisions in the domestic contract. For example one such provision might make the matrimonial home the sole property of the non-farming spouse. Another provision might permit an award of support based on the farming spouse's profits over a number of years and in that that way protect the assets of the business.

**The previous sections are intended only to raise the awareness of the family law and marriage contract issues with respect to farm corporations. They are in no way intended as legal opinion or advice. The reader should seek competent legal advice concerning their particular situation.**

### DOCUMENTS TO CONSIDER WHEN INCORPORATING

Any time you make a change in your business structure you will want to consider reviewing a number of your existing legal documents.

- **Wills** — If your will conflicts with the business agreement the business agreement takes precedence. It is very important to review your will when you draw up a new business agreement.
- **Power of Attorney** — A power of attorney is a document that allows individuals of your choosing to act on your behalf in the event you become incapable of managing your property or your personal care. Should you become incapacitated, a power of attorney would allow the business to continue operating with the least amount of disruption, and give other shareholders a measure of security.
- **Leases** — If certain assets, such as land, will be owned personally, and those assets are essential for the corporation to function, a lease agreement should be drawn up between the company and the owner of those assets.

- **Insurance Contracts** — Business insurance on the lives of key shareholders can allow the corporation to purchase the shares of the deceased shareholder from the surviving spouse. It is important that such insurance policies are set up and used properly to minimize tax on the death of a shareholder.

## CONCLUSION

Incorporating your farm business will become a suitable option for more farm businesses in the coming years. Taking the time to explore the alternative and understand the structure will help farm businesses to determine if incorporation matches their family goals and business objectives.

## APPENDIX 1 — STEPS TO FORMING A CORPORATION

### BASIC STEPS TO FORMING A CORPORATION

1. Select a name and submit it to a name search firm (you can submit the form with the name left blank followed by the words "Ontario Limited" and the companies branch will assign you a number name to your corporation)

2. Complete and file the Articles of Incorporation — these are forms that outline some of the basic operation and structure of your corporation. They include:

    - Name
    - Registered office — this is where the records of the company will be kept.
    - Number of Directors — you are able to have one or more directors or you can set a minimum or a maximum number. For flexibility you might want to state the number being from one to say 10 as a maximum.
    - First Directors — these are the names and addresses of the first set of directors. You can change the directors or the number of directors either through the procedures outlined in the Ontario *Business Corporations Act* or in the bylaws of the corporation (which is more common).
    - Restrictions — most companies do not place any restrictions on their business activities but they can do so if they wish.
    - Class of Shares — the Ontario *Business Corporations Act* requires the Articles indicate the classes of shares and the maximum number of shares the corporation is allowed to issue. There is no mention of type of share such as common or preferred.
    - Rights, privileges, restrictions, and conditions of each class of shares — If the corporation has more than one class of shares then the rights and privileges of each class must be stated. The right to vote and receive the remaining property must be attached to at least one class of shares (although they don't need to both be attached to the same class).
    - Restrictions, transfer, and ownership of shares — this article us allows the directors of the corporation to have a measure of control over whom will be allowed to be a shareholders in the company. Most often the article will state that all the directors or shareholders must agree to the sale or transfer of shares. *(The restriction on share transfer is one of the requirements for a company to be considered a private company. This is important because it ensures that you will not have to file a prospectus and registration, both being requirements of a public corporation)*
    - Other Provisions: Private Company Restrictions — in addition to the transfer of share restriction many companies include two further restrictions, which are also, requirements for private companies. There can be no more that 50 shareholders in a private company and you cannot offer shares to the public.
    - Other Consent — if a corporation wants to use a similar name to an existing corporation, partnership, sole proprietorship or of an individual then consent forms are filed with the articles. Existing businesses agree that they will discontinue business or change the name.

3. File the application with the Ministry of Consumer and Business Services, Companies Branch with the incorporation fee of $360.

4. If everything is in order the Director will issue a Certificate of Incorporation and return a certified copy of your articles of incorporation.

### RECORDS

The Ontario *Business Corporations Act* requires that certain corporate documents be kept at the registered office. Sometime the term minute book is used to indicate the bound or loose-leaf book that contains the following:

- articles of Incorporation, by-laws, and any unanimous shareholder agreements
- all resolutions of the corporation and minutes of meetings
- a registry of security holders and shareholders with appropriate details of each
- a registry of directors
- a registry of share transfers
- accounting records

## SOME DEFINITIONS AND EXPLANATIONS

**By-laws**

The by-laws are the set of rules that govern how the internal affairs of the corporation are conducted. Lawyers often have a standard set of these that can be used as a starting point. Usually they contain:

**Definitions of terms used in the by-laws**

*A section on the directors and officers*

- their election and term
- what a quorum is for a meeting
- details on meetings; when and where
- number of votes required to pass a question
- appointment of officers

*A section on shareholders*

- information on meeting, when where and how often, and notices to be given
- who is entitled to be a meetings
- voting methods and number of votes to pass a question
- who will be the presiding officer and appointment of scrutineers
- payment of dividends to shareholders

After by-laws are passed at the first meeting the directors should then:

- appoint officers who manage the day today operations of the business
- approve share certificates and authorize the issuance of shares
- adopt a corporate seal
- set a fiscal year
- appoint a banker and determine signing authority of officers

## RUNNING THE CORPORATION

The Ontario *Business Corporations Act* states that you can pass resolutions (like the ones above) in one of two ways: either by holding a meeting of directors or shareholders, or by written consent. In small companies the same person may fill the positions of director, officer and shareholder and as such written consent is most often used. Directors have the power to make, repeal or amend the by-laws (unless they indicate otherwise). All changes require approval from the shareholders at the first regular meeting after the change.

## ISSUING OR TRANSFERRING SHARES

Issuing of shares takes place when the corporation is established. These shares are issued from the treasury (i.e. the unissued pool of shares) of the company. New members can either be issued new shares from the treasury or they can have existing shares transferred to them. New shares can be issued from the treasury by a resolution from the directors who must decide the value at which they are issued. The individual can pay this amount or it can represent the sale of an asset to the company or represent past services rendered to the company. The issue of new shares has the potential to "dilute" the value of the current shareholders shares. If a share transfer is taking place you must follow any guidelines set out in the Articles of Incorporation. These would be any restrictions that may have been placed on the transfer of shares.

This publication is intended as general information and not as specific advice concerning individual situations. Although it outlines some of the legal and tax considerations of farm corporations it should not be considered as either an interpretation or complete coverage of the Income Tax Act or the various law effecting incorporation. The Government of Ontario assumes no responsibility towards persons using it as such.

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